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Economic Conditions
Governmental Finance
United States Securities

New York, November, 1937

General Business Conditions

THE business news has continued unfavorable during October. The weakness in both stock and commodity markets and the downward trend in various industries, notably in steel mill operations, have created uncertainty even in quarters where business is still good; and the tendency to curtail buying, work down inventories, and move with caution in all forward planning, has become more pronounced. Temporarily at least these developments have submerged the favorable factors.

Most business men were optimistic at the beginning of the Fall season. During the first half of the year both manufacturers and merchants bought ahead confidently, and during the Summer manufacturers were able to operate at high levels on unfilled orders, although new business was slack. For the Fall they expected the usual seasonal improvement, relying on the increased farm income and factory payrolls to keep business going and bring in new orders before important curtailment became necessary. However, sales are still slow, well past the time for the seasonal pickup; and so far as new business for the industries is concerned the Fall is an admitted disappointment.

Evidently the factor overlooked was that inventories, having been increased, would be shortened again if sentiment changed. Retail trade has improved since Labor Day, but the large chains, mail order houses and department stores had prepared for a good Fall and stocked up accordingly. Hence the retail sales are being supplied partly out of stocks, and buying from manufacturers is not in proportionate volume. In turn, manufacturers are shortening up on inventories of materials.

Meanwhile the markets have been spreading unsettlement. Many business men reject the theory that the stock market forecasts or even accurately reflects the business situation. They consider Wall Street unwarrantedly pessimistic, and deplore the attention that spectacular market movements receive. However, the fact that such violent movements influence business is generally accepted. Of course the state of confidence is important in business at all times, and the will to spend is diminished when the markets are proclaiming uncertainty. People have taken losses, even if only on paper, and they are poorer, or feel so, accordingly. The ability of the industries to raise new capital through the sale of stock has been temporarily impaired.

The action of the Federal Reserve Board in reducing the margin required on stock market loans from 55 to 40 per cent is calculated to be helpful in overcoming the market demoralization. It relieves pressure which was arising from technical factors. If margins are raised to prevent over-speculation in rising markets, it is entirely logical that they should be lowered when the opposite conditions prevail. The move is evidence of a readiness to alter Administration policies as conditions alter, which, if carried into fields more directly affecting trade and industrial activity, can unquestionably do much to lift the uncertainties.

The Decline in Production

According to preliminary figures, indexes of industrial production for October will show a substantial decline, whether compared with September or with October a year ago. Steel mill operations have had a particularly severe drop, off to 52 per cent of capacity from 85 the week before Labor Day. Textile mill activity is in a continuing down-trend. The copper industry is curtailing. Railway car loadings evidently made their seasonal peak in the first week of October, and have dropped below the corresponding figures for last year. The outlook for new buying of railway equipment this Fall is conceded to be poor, for although the I.C.C. has granted rate increases which will partly restore the emergency surcharges abolished last January, the increased revenue will not make up for the higher wages, taxes, and materials on one hand, and slackening traffic, on the other.

The decline in commodity prices has gone further during the month, and the drop in the staple commodities has been as severe as the

drop in the stock market. Moody's index of 15 of these commodities, including farm products and industrial materials, has fallen 22 per cent since August, finally wiping out all of the great advance last Winter and Spring.

To conclude this brief summary, there are a number of more favorable items. Mention has been made of improved retail trade, as compared with the disappointing figures of last Summer. Preliminary indications are that store and mail order sales in October have run around 8 per cent above last year. This is satisfactory despite the fact that most of the increase is accounted for by higher prices, for the comparison is with very good figures. Considering that merchants are desirous of reducing inventories, the good sales are important; they will hasten the correction, keep down cancellations and distressed liquidation, and keep the situation orderly.

Automobile assemblies during October have been larger than a year ago, and November and December are certain to be big months also. It is believed that the automobile companies will run "all out" through these two months, stocking dealers with new models, and if sales fail to reach the goals that have been set they will make the adjustments after the turn of the year. Expanding automobile production affords hope that the steel decline has about run its course; automobile companies are working down stocks of steel, and eventually they will be back in the market for current needs.

Causes of the Recession—Inventories

This description of the state of business could be elaborated in detail, but the facts are available in many places, and of course the questions of chief interest are how and why the recession has developed, and what are the factors to be considered in looking ahead. Within a short period business sentiment has changed from buoyant confidence to caution and uncertainty, and the markets have passed from boom to depression. What are the changes in the situation, as compared with last Spring, which account for this reversal?

The explanation of every fluctuation of business is to be found in the conditions preceding. The upward movement last Winter was rapid and vigorous. The demand for commodities was stimulated by increasing consumption, replenishment of inventories, anticipation of rising costs and prices, and purely psychological influences. It ran into temporary "bottle necks," including organized restrictions on production, which created an appearance of scarcity, and whetted further demands, for fear of delivery troubles. However, the scarcity was illusory. It was relieved by removal of restrictions and increases in production, and by the sales of speculators who had bought during the rise. When the markets turned down the inducement to build up inventories disappeared, and buying not only dropped to current requirements but fell below them as inventory positions were shortened. It appears now that forward buying on the rise was greater than generally realized at the time, while the shortening has been chiefly in recent weeks.

Undoubtedly this is one of the causes of the recession. The evidence is at hand in almost every industry. According to a summary of financial statements compiled by Standard Statistics, inventories of 140 industrial corporations on June 30 were 33 per cent higher, in dollars of course, than a year earlier. The cotton mills were sold so far ahead by last March that they operated at record rates through the Summer, although since March there has been hardly a week in which they sold their full production. The copper market also illustrates the situation. At prices between 10 and 14 cents last Winter, as the market rose, domestic sales averaged over 3,000 tons per day, but since the peak was reached in April business has been less than half that figure. Production was stimulated by the rise, and the decline eventually left the industry without sufficient orders to absorb the output, causing curtailment.

Business fluctuations arising from the causes described are normal and unavoidable; they require time to run their course, but unless they are complicated by other factors they are likely to be short and of minor importance. The current evidence is that reduction of inventories is well under way on the whole, and proceeding in orderly fashion, but of course the situation varies in different industries, and further curtailment especially in cotton mills is likely.

Cost and Price Relations

Another cause of business recessions is the tendency of costs and prices to get out of line during a rapid forward movement, so that some groups of the population, whose incomes do not advance commensurately, lose buying power. The readers of this Letter are familiar with the emphasis put upon the importance of balance among all elements in the economic system, and of equitable price relationships so that each producer can exchange his product for those of other producers on terms that will keep trade going. If the balance is disturbed trade is also disturbed.

In general, the relation between living costs and money incomes in 1937 measured relative to the preceding year, has been favorable, and this has been one of the strong points in business. Retail merchandise prices in recent months have been running about 8 per cent above a year ago, according to the Fairchild index, and the National Industrial Conference Board's cost of living index for September was 4.1 per cent higher. Both farmers and employed factory labor have had a greater increase than

these in their money incomes, and their purchasing power to that extent has increased.

To be sure, there are other groups of the population, such as people with fixed incomes, pensioners, and all who have not had increases in salaries or wages, and their buying power has been reduced by the higher prices.

The Profit Margin

What is more important, the industries have not been able to pass on all their cost increases in prices. Profit margins per unit have been reduced. Falling profit margins are not necessarily depressing as long as the volume of sales is constantly expanding, so that the return on capital is maintained, but they become a major factor when the volume turns down. Costs, including taxes, wages and fixed charges, contain elements that are hard to adjust, and reduced sales, especially in a time of falling prices, therefore cause a greater contraction in earnings. If earnings decline seriously the business situation is greatly affected. Capital values are reduced. Both the inducement to engage in new enterprise and the ability to finance it are impaired. The capital goods industries are the chief sufferers, and the depression has demonstrated the importance of these industries in the country's business. Evidently the stock market decline is due to concern as to earnings.

Moreover, the favorable view of price-income relationships is an over-all view, and there are exceptions where prices and costs are out of line so that volume is restricted. The decline in building activity in recent months is attributed in almost all sections to the rise in wage and material costs last Spring. Building has declined more than seasonally since Spring; in September total contracts awarded were 11.6 per cent below a year earlier, and in the first half of October they were 10.4 per cent lower. Residential building, of which much had been hoped, showed 18.7 and 22.5 per cent decreases respectively.

Finally, will factory workers' incomes hold their favorable relation to living costs, with factory operations on a lower scale? It is obvious that payrolls will decline if hours of work decline for any reason, which is another demonstration of the truth that while hourly wage rates can be fixed and pegged, weekly and annual wages and real purchasing power are uncontrollable.

When costs and prices get out of line to the point of disturbing trade and causing unemployment there is no remedy except to make corrections wherever necessary, and postponement of the correction prolongs the trouble. The building situation requires lower costs, which cooperation among all elements in the industry could give, or higher rents and values, which no one can control. In the general price structure the drop in raw materials has checked the rise in finished goods, and in some lines, including building materials, woolen and cotton goods, and various items of apparel, prices of finished goods have been marked down. This is a helpful policy, and if it is carried out wherever costs permit it will do much to keep business in balance. Of course the emphasis belongs on costs.

Debt-Making and Debt-Paying

An important cause of fluctuations of business in the past has been the alternation of periods of debt-making and credit expansion with their inevitable sequels of debt-paying and credit contraction. The traits of human nature themselves are responsible for these fluctuations, for under the influence of mass psychology people readily fall into extremes of borrowing and over-investment in new ventures, continuing until capital becomes scarce, money tight, and the reaction develops.

Fortunately this has little application to the present situation, and is mentioned to emphasize the contrast. There is no tightness of money, on the contrary an abundance at cheap rates; and considering the low level of construction, railway and public utility equipment installation, and similar items, it is agreed that capital investment has not been overdone. As for bank credit, the total of all bank loans plus investments in other than Government securities, as reported by the Federal Deposit Insurance Corporation for June 30 last, was $24,200,000,000. This compares with a similar figure of $54,100,000,000 for all banks on June 30, 1929.

Considering loans on securities only, the reporting member banks were lending on the first of October, 1929, for themselves and others, almost $12,000,000,000; and the present figure corresponding to this total is about $3,000,000,000. However severe the decline in the stock market or in business, obviously there can be no comparable liquidation of debt, the repayment of which drained current purchasing power after the 1929 crash.

Consideration of debts outside the banking system would not materially change these conclusions. It is true that there is a huge Government debt to offset the lower private debt. The insured banks on June 30 held $14,000,000,000 of Government securities, against $3,800,000,000 for all banks on June 30, 1929. The Government debt is a cause of anxiety in looking ahead, but for the purpose of this discussion we will only say that liquidation of this debt obviously is not to be expected at this time.

Government-Created Purchasing Power

Another group of influences causing fluctuations in business are the external factors, including Government policies. The Government has been a prolific creator of purchasing power during the recovery. It has covered its deficit

in part by borrowing from commercial banks as above indicated, and this has created credit. This credit has been new purchasing power. It has been expended on construction, relief, farm payments and in other ways, and has put money directly into people's pockets, in such large totals as to be a major influence in the upswing.

Analysts of all opinions have agreed upon two conclusions with respect to this policy: first, that it could not be continued indefinitely; second, that no one could affirm with certainty that the recovery was sound and lasting as long as it was receiving so much support from Government credit, which might cover up a failure to make the adjustments by which business would become self-supporting. It has long been apparent that the end of the policy would afford a test of the recovery's vitality, and that the transition to a privately-financed recovery would involve problems, since an expansion of private spending would be necessary to compensate for the Government's curtailment.

That stage in the recovery has been reached during the past few months. Government expenditures have not been reduced, but are covered in greater part by taxes. The budget has not been balanced, but the deficit requires no borrowing from banks (except for funds to pay for gold imports), since Social Security receipts and other trust funds in the Treasury, available for investment in Government obligations, are sufficient to cover it. President Roosevelt described this clearly in his budget statement on October 18, in the following terms:

> There are included in the total expenditures for 1938 investments in special government obligations in the amount of $575,000,000. In addition, contributions to be made by the States to the unemployment trust fund will likewise be invested in special government obligations in the net amount of $500,000,000.
>
> Thus, public debt receipts made available from the sale of these special obligations to investment accounts in the amount of $1,075,000,000 will be used to finance the deficit of $695,000,000 and lessen the debt in the hands of the public by $380,000,000 . . .
>
> This does not take into account any change in the public debt which may occur as a result of the Treasury policy with respect to the sterilization of gold.

Therefore the Government is no longer expanding credit and creating purchasing power; it is taking purchasing power from tax payers and routing it through Government channels to other people, but not adding to the total. Moreover, the use to which part of the tax collections are put is unproductive.

As an offset to this curtailment, private spending and investment have been running larger this year, as indicated by the greater activity of the capital goods industries, increased commercial loans by banks, and a moderate rise in new corporate financing earlier this year. But new financing temporarily is at a standstill, and at best the totals have been discouragingly small. On the whole, the discouragement to private investment, which is needed to replace the Government spending, still persists; and at the moment it is acute due to market unsettlement and business uncertainty. Of course the reduction in the deficit, and the approach of the budget nearer to a balance than in five years, are themselves encouraging to private enterprise, but this is only one among many factors.

In Conclusion

The foregoing comments are lengthy, and they will bear summarizing as to the causes of the recession and the policies that will keep it within bounds and get the recovery going again. There is no evidence that business sentiment is demoralized; that business men are conducting their affairs with less energy and application; or that any significant number fear a return to 1932 conditions. On the contrary, the most common sentiment is that the stock market, perhaps for technical reasons within itself, has overdone its decline and has spread an unjustified pessimism. The reaction of most business men has been to shorten up inventories and wait until the situation is clearer, but this policy is adopted out of common prudence and recognition of the slackening now occurring, rather than any belief that a major depression has begun. In due course the abstention from buying will correct the inventory situation, and the correction has started at a rapid pace, both in the markets and in industrial production.

Reductions in costs are needed, especially in building, and the decline in construction has already put pressure on building costs. The pinching of the profit margin that all business is under as the result of increased wages and taxes, now coupled with a decline in volume, is one of the unfavorable features, and this itself will stimulate the search for lower costs.

If the recession is due chiefly to over-stocking and special instances where costs and prices are out of line, it will be of an intermediate character, and past precedents suggest strongly that it is of that type. There is no great body of debt that will be liquidated, no credit stringency, and no overexpansion of fixed investments. Real estate is already deflated, and agriculture is in shape to give industry support. All these are arguments that the slackening will run itself out in due course, and perhaps is nearer a leveling out, at least, then the markets now appear to believe.

The Need of Private Investment

On the other hand, no realistic person would wish to minimize the uncertainties in the situation, for they are of a character that can be averted by facing them squarely. Incomparably the greatest need now, as it has been throughout the recovery, is to get private investment going. To sustain business in this country the accumulation of savings and the flow of capital into productive use have always been necessary, and there is no evidence that it is any less

necessary than heretofore. Many studies have indicated that almost half of American business is normally in the capital goods industries, including housing, and these industries depend upon savings and investment. They are not over-expanded, they will keep going if the necessary conditions are fulfilled, and if they do the business recession will not be prolonged.

The rate of saving and investment is greatly influenced by Government policies, notably by taxation, and unquestionably there is ground for reviewing the tax system for the purpose of determining how capital accumulation may be encouraged through tax revision. Other Government policies also are restrictive of profit, hence of investment, and discouraging to enterprise. Any policies which are working against the reopening of the capital markets, whether they affect the lender or the borrower, and whether they operate directly or through the general business situation, are working against recovery.

To say that reduction of Government spending is a factor in the recession is not an argument for its resumption. Renewed spending would merely put off the inevitable. Sooner or later business will have to become self-supporting, and the longer the deficit spending is continued the worse the situation will ultimately be. The choice as between the two alternatives should be clear.

If space permitted some attention would be given to the international situation, for when recession appears here one of the important questions is whether it will appear elsewhere, and become world-wide. However, the discussion would be inconclusive, for the unknown elements are as great as here. The latest reports of trade and industry in most foreign countries tell of sustained activity. Some of our industries are receiving substantial support from export orders which help to offset the drop in domestic business.

Money and Banking

The money market has remained easy during the past month, with excess reserves of all member banks ranging somewhat over a billion dollars. For the New York City banks alone, excess reserves, after rising to $400,000,000 following "de-sterilization" of inactive gold in September, dropped to $259,000,000 on October 13, recovering to $375,000,000 by the 27th.

Reflecting the existence of large excess reserves, and assurances of further Federal action to maintain reserves if needed, money rates have continued under pressure, with a further slight softening of the sensitive rates on Treasury bills.

Contrasting with the action of the stock market, Government and other high grade bonds experienced only moderate fluctuations and closed with a generally firm tone. Second grade bonds, on the other hand, weakened with the share market.

With the recession of business now in progress, it is evident that basic factors are working towards continued monetary ease. Already the liquidation in the stock market has brought about a substantial reduction in brokers' loans, while, as described in the preceding article, Federal credit needs, apart from borrowing in connection with gold purchases, may be taken care of without further resort to the market for new money.

Demand for currency will increase between now and Christmas, but thus far the Fall expansion of currency demand has fallen short of expectations; in any event it may be taken for granted that the Federal authorities will provide ample credit for all seasonal needs.

Decline in Bank Credit

At the weekly reporting member banks, the trend of credit outstanding has continued downward, reducing total loans and investments by $156,000,000, and total deposits by $140,000,000, during the four weeks ended October 20, the figures in both cases touching new low levels for the year.

In the case of loans and investments, the decline may be largely accounted for by a drop of $168,000,000 in loans made for the purpose of purchasing and carrying securities (including brokers' loans), accompanying liquidation in the stock market. Loans for commercial, industrial and agricultural purposes continued to increase during the greater part of the period, but in the final week showed a reduction of $31,000,000, the first break, save for a nominal decline at the end of July, in an otherwise uninterrupted advance extending over seventeen weeks and amounting to over half a billion dollars. It might be added that commercial borrowing frequently reaches a seasonal peak around the middle of October, though last year when business was undergoing expansion the high point was not reached until December. Considering the receding tendency of business, a change in the trend of commercial borrowing was to be expected and is probably a favorable sign, indicating that business is reducing, rather than accumulating, inventory. On balance, the aggregate of all loans of the reporting institutions dropped approximately $100,000,000 during the period under discussion, the remaining decrease in total loans and investments being in holdings of investment securities—United States Government issues and others.

For the week of October 27 figures published for New York City reporting banks alone indicated a further reduction in loans of both commercial and financial categories. Investments in Government securities, on the other hand, increased.

Third Quarter Profits

Reports issued during the past month show that leading corporations in many lines of industry continued during the third quarter to increase their volume of business and net profits over those of last year. In a number of other lines of industry and trade, however, and also in the case of railroad and public utility systems, the recession in activity or the rising level of costs, or both, caused the returns of numerous concerns during the third quarter to fall below those of a year ago.

A tabulation of the published reports of 265 industrial corporations shows combined net profits, less deficits, of approximately $343,000,000 in the third quarter of this year, which compares with $402,000,000 for the same companies in the preceding quarter and with $290,000,000 in the third quarter of last year. The percentage gain of the third quarter over 1936 was 18.1, while the gain over last year of a similar group of companies in the second quarter was 24.0 per cent and in the first quarter 53.5.

About three out of every five companies showed an increase of third quarter profits over last year, whereas during the first six months about four out of every five reported gains. The reason for the more widespread decreases despite the generally higher level of sales is, of course, the sharp rise in operating costs this year, resulting from the increase in wages, shortening of hours, higher prices paid for raw materials purchased and higher taxes, including the unemployment and pension taxes upon payrolls. Where these increased costs were not passed on to consumers by an increase in selling prices, the margins of profit have been narrowed, and in some cases wiped out.

Following is a condensed summary of the results for the third quarter:

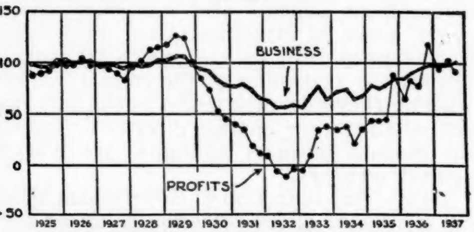
Industrial Corporation Profits for Third Quarter, 1937, and Percentage Change from 1936
(In Thousands of Dollars)

No.	Industry	Third Quarter 1937	Per Cent Change 1936-37
1	Autos—General Motors	$ 44,413	+ 28.2
5	Autos—Other	9,748	— 24.2
19	Auto Accessories	6,381	+ 6.7
5	Baking	5,669	— 10.2
13	Building Materials	6,640	+ 9.0
14	Chemicals	43,602	+ 3.5
8	Coal Mining	D-361	....
8	Electrical Equipment	23,174	+ 44.5
13	Food Products—Miscel.	10,494	— 43.8
6	Heating and Plumbing	4,762	— 8.5
7	Household Gds. and Sup.	7,024	— 20.2
1	Iron & Steel—U. S. Steel	30,618	+124.5
23	Iron & Steel—Other	35,871	+ 33.0
19	Machinery	9,013	+ 34.9
7	Merchandising	2,240	— 17.2
11	Mining, Non-ferrous	28,832*	+ 41.3
5	Office Equipment	2,792	+ 54.7
9	Paper Products	4,333	+ 76.3
16	Petroleum	34,907	+ 25.1
8	Railway Equipment	8,002	+ 26.6
8	Textiles and Apparel	2,244	— 20.7
45	Miscel. Manufacturing	18,726	+ 6.6
14	Miscel. Services	3,804	— 12.4
265	Total	$342,928	+ 18.1

D- Deficit. * Before certain charges.

An outstanding gain in sales and profits for the third quarter was made by the steel industry, whose high rate of operations did not taper off materially until toward the end of September. Without the 24 steel companies, the increase in third quarter profits for the industrial group would have been but 10.4 per cent, instead of 18.1 per cent.

The quarterly trend of profits over a period of years is shown in the chart giving an index computed from the rate of return on net worth of 200 leading corporations and adjusted for season variations, together with the Annalist Index of Business Activity.



Quarterly Index of Industrial Corporation Profits and the Annalist Index of Business Activity. 1926 = 100

The Nine Months' Profits

Cumulative figures for the 265 leading industrial companies for the first nine months show net profits of approximately $1,080,000,000 this year as compared with $835,000,000 in the corresponding period of a year ago, an increase of 29.4 per cent. Without the steel group, the increase would have been 16.0 per cent.

These companies had an aggregate net worth of $11,025,000,000 at the beginning of the year, upon which the nine months' profits were at the *annual rate* of 13.0 per cent, as compared with a rate of 10.4 per cent last year. It is noteworthy that large numbers of representative companies have already reported profits for the first nine months of 1937 in excess of those for the entire year 1936. On the other hand, the earnings of many other companies for the full year 1937 will show a decline as compared with 1936, reversing the upward trend that had prevailed since 1932.

In most cases the net profits as reported for the third quarter and nine months do not give effect to accounting adjustments and reserves for inventory valuation, notes and accounts receivable, investments, etc., nor to the operation of the penalty surtax of 7 to 27 per cent on undistributed income, the liability for which is not commonly set up until after the close of the fiscal period.

The following tabulation summarizes, by major industrial groups, the comparative net profits for the first nine months, aggregate corporate net worth and annual rate of profits return. It will be observed that the best gains this year were made by such heavy or capital goods industries as iron and steel, non-ferrous

INDUSTRIAL CORPORATION PROFITS FOR FIRST NINE MONTHS
Net Profits Are Shown After Depreciation, Interest, Ordinary Taxes, and Other Charges and Reserves, but Before Dividends.
Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.
(In Thousands of Dollars)

No.	Industry	Net Profits Nine Months 1936	Net Profits Nine Months 1937	Per Cent Change	Net Worth January 1 1936	Net Worth January 1 1937	Per Cent Change	Annual Rate of Return 1936	Annual Rate of Return 1937
1	Autos—General Motors	$175,199	$154,958	— 11.6	$930,667	$970,843	+ 4.3	25.0	21.3
5	Autos—Other	46,642	41,313	— 11.4	163,093	175,695	+ 7.7	38.0	31.4
19	Auto Accessories	26,641	29,417	+ 10.4	171,723	187,497	+ 9.2	20.6	20.9
5	Baking	16,182	14,098	— 12.9	217,717	219,625	+ 0.9	9.8	8.5
13	Building Materials	12,670	19,589	+ 54.6	233,262	248,937	+ 6.7	7.2	10.5
14	Chemicals	114,500	128,309	+ 12.1	1,036,955	1,100,980	+ 6.2	14.6	15.4
8	Coal Mining	750	D-222	—	77,013	71,164	— 7.6	1.2	......
8	Electrical Equipment	44,287	69,108	+ 56.0	604,016	579,189	— 4.1	9.7	15.8
13	Food Products—Miscel.	49,590	40,736	— 17.9	485,508	490,631	+ 1.1	13.6	11.0
6	Heating and Plumbing	8,191	11,128	+ 36.0	147,779	154,059	+ 4.2	7.4	9.7
7	Household Gds. and Sup.	20,615	24,947	+ 21.0	164,358	169,463	+ 3.1	16.6	19.6
1	Iron & Steel—U. S. Steel	29,875	95,353	+219.2	1,564,373	1,564,517	+	2.5	8.1
23	Iron & Steel—Other	58,616	114,171	+ 94.8	1,456,105	1,514,612	+ 4.0	5.3	10.0
19	Machinery	17,285	26,489	+ 53.2	131,961	147,424	+11.7	17.3	23.9
7	Merchandising	5,540	6,403	+ 15.6	61,029	72,907	+19.4	12.1	11.7
11	Mining, Non-ferrous	55,818*	91,586*	+ 64.1	877,527	937,146	+ 6.8	8.5	13.0
5	Office Equipment	6,614	11,458	+ 73.2	75,032	77,050	+ 2.7	11.7	19.7
9	Paper Products	4,739	13,280	+180.2	204,244	197,353	— 3.4	3.1	8.9
16	Petroleum	63,777	87,571	+ 37.3	961,663	1,022,593	+ 6.3	8.8	11.4
8	Railway Equipment	13,603	27,097	+ 99.2	403,591	411,494	+ 2.0	4.5	8.8
8	Textiles and Apparel	7,436	7,901	+ 6.3	64,622	66,856	+ 3.5	15.3	15.7
45	Miscel. Manufacturing	47,560	58,048	+ 22.1	432,540	451,379	+ 4.4	14.6	17.2
14	Miscel. Services	8,470	7,368	— 13.0	208,480	193,833	— 7.0	5.4	5.1
265	Total	$834,600	$1,080,106	+ 29.4	$10,673,258	$11,025,247	+ 3.3	10.4	13.0

D- Deficit. * Before certain charges.

metals, building materials, electrical equipment, household equipment, office equipment, railway equipment and machinery generally, as well as paper and petroleum.

Margin of Profit on Sales

A list is given of some 40 of the more important manufacturing corporations whose interim reports contain sales figures, and of a similar group of the larger chain store, department store and mail order organizations, with the percentage change in sales for the first nine months of 1936 and 1937. This indicates the excellent gains in total receipts and in physical volume of business by many corporations this year, after allowance for higher selling prices.

Per Cent Change in Nine Months' Sales, 1936-1937

Manufacturing		Merchandising	
Air Reduction Co.	+17.9	American Stores Co.	+ 0.3
Allis-Chalmers Mfg.	+53.8	Barker Bros. Corp.	+22.3
American Colortype Co.	+16.2	Bond Stores, Inc.	+20.3
American Radiator Co.	+25.5	Consol. Retail Stores	+ 9.5
Atlas Powder Co.	+15.1	Crown Drug Co.	+ 3.4
Baldwin Locomotive	+73.4	Edison Bros. Stores	+24.4
Barber Company	+25.8	Fanny Farmer Candy	+17.8
Beatrice Creamery Co.	+ 8.7	M. H. Fishman Co.	+ 5.5
Caterpillar Tractor	+29.1	Grand Union Co.	+ 8.5
Continental Oil	+19.9	W. T. Grant Co.	+ 3.5
Continental Steel	+25.4	H. L. Green Co.	+ 9.4
Florence Store Co.	+27.4	Interstate Dept. Stores	+ 3.2
General Electric Co.	+37.8	Jewel Tea Co.	+15.2
General Motors Corp.	+13.5	S. S. Kresge Co.	+ 5.6
General Refractories	+38.2	S. H. Kress & Co.	+ 2.4
Hercules Powder Co.	+35.3	Kroger Groc. & Bak.	+ 5.9
Interlake Iron Corp.	+58.1	Lane Bryant, Inc.	+ 5.0
Johns-Manville Corp.	+33.0	Lerner Stores Corp.	+ 9.3
Kimberly-Clark Corp.	+21.1	McCrory Stores Corp.	+ 3.0
Link Belt Co.	+35.9	McLellan Stores Corp.	+ 6.9
Lone Star Cement	+21.0	Melville Shoe Corp.	+12.8
Maytag Company	+10.6	Montgomery Ward	+23.0
Mengel Company	+21.4	G. C. Murphy Co.	+15.7
Minn.-Honeywell Reg.	+32.7	National Tea Co.	+ 2.6
Nat'l Cash Register	+24.7	Neisner Bros., Inc.	+ 8.3
Otis Elevator Co.	+40.0	J. J. Newberry Co.	+ 6.1
Phillips Petroleum	+17.6	J. C. Penney Co.	+ 8.5
Remington Rand, Inc.	+21.3	Peoples Drug Stores	+ 8.7
Ruberoid Company	+23.1	Reliable Stores Corp.	+13.2
Shell Union Oil	+13.9	Rose's 5-10-25c Stores	+ 9.4
Sharon Steel Corp.	+14.1	Safeway Stores, Inc.	+13.4
Superior Steel Corp.	+51.1	Schiff Company	+ 6.4
Thatcher Mfg. Co.	+ 9.0	Sears, Roebuck & Co.	+14.4
Tide Water Assoc. Oil	+20.0	Spencer Shoe Corp.	+30.5
Union Oil Co.	+26.8	Spiegel, Inc.	+28.3
United Aircraft	+20.5	Sun Ray Drug	+13.3
U. S. Hoffman Machy.	+31.9	Union Premier Food	+58.4
Wesson Oil & Snowdrift	+17.3	Walgreen Co.	+ 8.7
Westinghouse Electric	+33.5	Western Auto Supply	+53.8
Wheeling Steel Corp.	+26.5	F. W. Woolworth Co.	+ 5.9

The comparison of net profits with such sales figures as are available shows that the tendency toward holding down the *margin of profit* (if not the actual dollar profits) that was revealed in the second quarter continued during the third. Taking a sample group of 40 large manufacturing corporations, the combined sales, net profits and margin of profit have been as follows:

Sales and Profits of 40 Leading Manufacturing Corporations
(In Thousands of Dollars)

Period		Sales	Net Profits*	% Profit
1935	Year	$3,352,004	$323,707	9.6
1936	First Quarter	943,696	96,336	10.2
	Second Quarter	1,208,877	157,353	13.0
	Third Quarter	941,318	104,287	11.1
	Nine Months	3,093,891	357,976	11.5
	Fourth Quarter	1,147,905	148,200	12.9
	Year	4,241,796	506,176	11.9
1937	First Quarter	1,109,100	114,931	10.4
	Second Quarter	1,410,403	155,499	11.0
	Third Quarter-P.	1,200,000	130,000	10.8
	Nine Months	$3,719,503	$400,430	10.8

*Includes income from investments and miscellaneous sources, in addition to income from sales.
P-Preliminary.

In the first quarter of 1937, total sales of this group increased 17.5 per cent over those of 1936, but the average profit margin rose only

from 10.2 to 10.4. In the second quarter of 1937, with a 16.7 per cent increase in sales, the profit margin declined from 13.0 to 11.0. In the third quarter, which is partly estimated, there was an increase of 27.5 per cent in sales, but the profit margin declined from 11.1 to 10.8. These substantial increases in sales without a sharp increase in profit margins seem extremely significant, for the reason that they are so contrary to normal experience of the past.

The showing of this sample group of 40 corporations, representing combined sales of more than $4,200,000,000 last year, is indicative as to trend, but does not afford an accurate measure of average margins in industry generally, for while in 1935 the rate for this group was 9.6 per cent, the average rate for all manufacturing corporations in the United States, according to the preliminary official Statistics of Income, was but 3.04 per cent.

Railroads and Utilities

Freight and passenger revenues of the Class I railroads were 13.5 per cent ahead of last year in the first quarter, 9.5 in the second and only 2.7 per cent ahead in the third quarter. In the face of this diminishing rate of gain in gross revenues, there has been a marked rise in operating costs due to higher wage rates granted to both operating and non-operating employes, increased taxes for unemployment and pensions, and increased prices paid for coal, fuel oil and other materials and supplies purchased. Railway operating income, after deducting operating expenses and taxes but before interest charges, ran ahead of last year from January to June, but since then has fallen sharply below the figures of a year ago.

A group of 25 of the more important systems supplying electric light and power, gas and other services, which have issued reports for the twelve months ended September 30, shows an increase of 4.7 per cent in combined gross revenues as compared with a year ago, but a gain of only 5.2 per cent in net income after charges. The American Telephone & Telegraph System for the twelve months ended August 31, reported an increase of 7.0 per cent in operating revenue and a gain of 16.6 per cent in net income. For the quarter ended August 31, however, there was an increase of 5.8 per cent in operating revenues and a *decrease* of 5.9 per cent in net income.

The Cotton Situation

The cotton situation is certain to be threshed out again at the special session of Congress, which has been called partly for the purpose of enacting new farm legislation. It is indisputable that a "cotton problem" exists, for despite the years of effort to improve the situation, cotton supply and demand are almost as badly out of balance as they were at the bottom of the depression. The price is sharply below a year ago, and probably would be even lower except for Government loans; and cotton growers' cash income would be very much lower than last year were it not for Government payments and market support. Moreover, the problem is more complex and difficult than it was in 1933, by reason of the phenomenal increase in foreign cotton growing and the narrowing of the world market for our cotton.

There are many persons familiar with the situation who sincerely believe there would be no cotton problem today but for the Government intervention that has persisted since 1929, but of course this belief does not protect the market from continued intervention. The strongest opponents of the program recognize that at present Government withdrawal is impracticable. After following policies which have contributed greatly to the loss of one-third of the foreign market, it would be hard to justify throwing cotton growers back upon their own resources, with a crop that is possibly 5,000,000 bales greater than the markets need. On the other hand, it is plain that no lasting progress has been made toward balancing production and demand, or toward making the cotton growers prosperous on a self-supporting and therefore lasting basis. As long as the markets are out of balance the drafts on the Treasury for "benefits" and "adjustment payments," to "equalize" the income of cotton farmers with that of other groups, will burden the tax payers.

Surplus Accumulating Again

In Memphis on October 1, Secretary Wallace made a speech devoted to the cotton situation, in which he described the improvement in the economic condition of the South, but added "There is today in the South a widespread feeling of uncertainty. There is a feeling that the measures which have sufficed to bring income gains in the last four years will not produce further gains." During those four years the surplus of cotton accumulated during the depression was steadily reduced. The stock impounded by the Government, in the first place through Farm Board operations and later through the various loan programs, was brought down from the high of 6,075,000 bales in March, 1936, to 1,693,000 at the end of the 1936-37 season. However, the reduction was due chiefly to short crops, and most of the gain of four years will be lost this season.

The American cotton crop this year, estimated as of October 1 at 17,573,000 bales, is the second largest ever harvested. Foreign crops, estimated by the New York Cotton Exchange at 20,100,000 bales, are by far the largest on record. Including the carryover of all cotton at the beginning of the season, the total supply is almost 51,000,000 bales, which is 6,500,000 bales larger than last season, and compares with a world consumption then of 31,000,000.

The prospect for consumption is less favorable than a year ago, due to a probable decline in this country and the Far East. In any event, it is certain that the surplus remaining at the end of the season will be the largest ever known, and the probable carryover of American cotton on July 31, 1938 is 11,000,000 bales.

The following table gives the essential statistics for both American and foreign cotton, compiled by the New York Cotton Exchange:

(American cotton in running bales. Foreign cottons in 478-pound bales)

	Production	World Consumption	End-season Carryover
	American Cotton		
1928-32, ave.	14,596	13,276	8,150
1933-34	12,712	13,820	10,701
1934-35	9,576	11,236	9,041
1935-36	10,495	12,538	6,998
1936-37	12,375	13,138	6,235
1937-38	17,350 pre.		
	Foreign Cotton		
1928-32, ave.	10,877	10,882	5,588
1933-34	13,354	11,822	6,839
1934-35	13,474	14,282	6,031
1935-36	15,825	15,205	6,651
1936-37	18,325	17,898	7,078
1937-38	20,100 pre.		
	All Cotton		
1928-32, ave.	25,473	24,158	14,538
1933-34	26,066	25,642	17,540
1934-35	23,050	25,518	15,072
1935-36	26,320	27,743	13,649
1936-37	30,700	31,036	13,318
1937-38	37,450 pre.		

Prices and Government Payments

Reflecting the overproduction, the cotton price dropped temporarily to 7½ cents in New York on publication of the October crop estimate, which compares with an average of over 12 cents last season. However, the Government is making loans again, at 9 cents for middling ⅞" or better and lower prices for lower grades, and in the long run the market seems likely to return to the loan level. The surplus production evidently will lodge again in the Government stock, and at the end of the season this stock may exceed the previous high of 6,075,000 bales.

The Government is also paying farmers on a part of their production (that part grown on 65 per cent of their base acreage under the Soil Conservation Act allotments) the difference between their selling price and 12 cents, not exceeding 3 cents a pound. In addition the farmers cooperating in the Soil Conservation program receive payments of around 2 cents. On part of his crop, therefore, the farmer may receive 5 cents a pound above the market price, and on the remainder at least the loan value. The 5 cents is a direct charge on the Treasury, and the Treasury will absorb the loss, if any, on the loan cotton. Thus the farmers' income is protected, at the expense of the Treasury.

If this subsidy were non-recurring, confined to an emergency, it might be accepted as worth the cost. But the payments have been going on for four years, and it is in order to ask whether they are not self perpetuating. In short, is the Government program itself causing a continuous unbalance between supply and demand, continuously depressed markets, and a continuous demand for subsidies to protect the grower, all going along together without any determinable end?

The Increase in Foreign Crops

It is certain that the Government program has reduced the cotton acreage, but it is doubtful whether it has permanently reduced production; and indisputably it has reduced consumption of American cotton abroad. The most important development of the past four years has been the rise of production outside of the United States. As shown by the foregoing table, foreign crops have increased by 9,223,000 bales, or 85 per cent, over the 1928-32 average, and have approximately doubled since 1927-28. All the efforts to support the market for the benefit of the American farmer have had the effect of holding the price of American cotton relatively high compared to those of foreign growths. Expansion of cotton growing has been encouraged in every country in the world where climatic conditions are suitable.

Secretary Wallace does not concede that the policies of this country are wholly responsible for the growth in foreign production, and it is doubtless true that the trend would have been upward in any event. But the evidence of market prices is incontrovertible. Under the Government program the price of American cotton for extended periods has been higher relative to prices of other growths than in the past. A normal growth of foreign production could have been absorbed by increasing world consumption, but the abnormal expansion under the "umbrella" held by this country's price-pegging policies has narrowed our export market by at least 3 million bales.

Increasing Yields Per Acre

The Government program has assumed that American cotton production can be effectively controlled, on the average, but there may be doubts on this point also. The crop this year, which was raised on 33,700,000 acres, is only 400,000 bales smaller than the all-time record crop of 1926, which was raised on 44,600,000 acres. The yield per acre, approximately 250 pounds, is by far the largest ever made. This yield is in part due to exceptionally favorable weather, and of course the crop cannot be expected to do as well every season. However, all the influences are in the direction of increasing the yield. Under the Soil Conservation Act the Government is paying each farmer, in effect, to concentrate his crop on his best land. He can cultivate the smaller acreage more intensively, and can apply improved cul-

tural methods, including those for controlling the boll weevil more effectively. Moreover, acreage measurements under the conservation program have been more rigid, excluding roads, ponds, etc., and as compared with the figures a few years back the present acreage is understated. This change in statistical method naturally makes the calculated yields higher. It is the opinion of close students of cotton growing that yields of above 200 lbs. will become the rule rather than the exception. Upon an acreage of 29 to 31 million, which is probably the practicable limit of curtailment, average crops of around 13,000,000 bales, running in good years up to 15,000,000, seem within the possibilities.

With this prospect here, foreign production up to the 20,000,000 bale level, and the heaviest carryover ever known, the probability is that cotton will have to sell at a price which will restrict foreign acreage, before the markets can be balanced. What that price is remains to be seen. Possibly in some areas continuation of this Fall's low prices would at least check expansion. In any event it is hopeless for any cotton-producing country to seek to support its own growers by price-pegging. Too many countries are now in the business.

Miscalculations of the Cotton Policy

The loss of exports under the Government program has been due in part to a conscious policy, and in part to the miscalculations of the planners. These miscalculations include the underestimation of the possible expansion of cotton growing abroad; the fixing of loan values too high, especially in 1934-35, so that the loan pegged prices above economic values; and possibly underestimation of American production. The concept of a "parity price", i.e., that cotton prices should be raised to the same ratio with respect to prices of things farmers buy as prevailed in 1910-14, was responsible for many of the early mistakes. This goal was set forth in the Agricultural Adjustment Act of 1933. It had great practical importance, for it raised the aspirations of cotton farmers and their representatives too greatly and was responsible for setting the loan values too high. To demonstrate the futility of the concept, it is only necessary to say that the parity price at present, under the above definition, is 16.7 cts.

Secretary Wallace has become the foremost critic of this concept. In his annual report for 1935 he pointed out that "Parity prices established on a very high level through excessive reductions in the farm output would not last. . . . Beyond a certain point price gains at the expense of sales involve a loss of income." The Soil Conservation Act of 1936 embodied the principle of "parity income," abandoning "parity price." Applied to cotton especially, there is a significant difference between the two. Mr. Wallace has described this difference better than anyone else, in his Memphis speech. He pointed out that the parity price, 16.7 cents a pound, could be reached only if the growers were willing to give up exports entirely, and go on a domestic basis. He continued:

> At such a price competition from rayon and other fabrics would probably increase to a point which would make it impossible to pass into domestic consumption more than 7 million bales. At average yields that amount could be produced on about 18 million acres. Suppose we did this. Disregarding the value of the cottonseed, such a crop would be worth 130 million dollars less than the present crop at 9 cents a pound. If producers were asking consumers to pay the 16.7 cent price, they would not be likely to get subsidies besides. So this extreme emphasis on price at the expense of volume would mean a substantial loss in cash income to the South.

Unfortunately not everyone of influence among cotton growers, and in Congress, has given up the parity price idea, but the Administration no longer entertains it. The loan this year is little more than half the parity level.

Mr. Wallace is also a severe critic of those who would use loans primarily for price maintenance. He defends the 10-cent loan of 1933, but omits mention of the 12-cent loan of 1934, which may imply admission that it was a mistake. He said in his speech:

> If loans are used for any length of time to keep the market price in this country above the prices at which producers in other countries are willing to sell, they have two results that in the long run are very bad. One is that the government gets a huge supply of cotton. This cotton is difficult to move into market channels without upsetting prices and ruining the farmer. The other bad result is that while the loan is in effect cotton is prevented from moving freely into export because foreign cotton which is unaffected by any such loans can be had at lower prices.

Mr. Wallace considers that the 9-cent loan this season will serve a useful purpose as "helping to check the price decline." But whether 9 cents is a sound economic value for cotton is an opinion rather than an impartial decision of the markets; and if 9 cents is too high, the results described by Mr. Wallace will follow from the present loan as they did from its predecessors. However, it is evident that much has been learned since 1933 as to the effect of loans, otherwise pressure for a price nearer the parity level might have brought a higher loan this year, which would have been disastrous.

Withdrawing from Foreign Markets

Aside from the miscalculations, the loss of exports proceeds from a conscious policy, as has been stated. The intent of the program has been to withdraw from foreign markets to some extent, on the ground that to compete with other producers at the prices for which they will grow cotton would result in an intolerable standard of living for American growers.

Mr. Wallace has little patience with those who oppose all restrictive influences on cotton production. He insists that unrestricted crops would mean "a return of all the suffering and privation which the farmers of the South en-

dured in the darkest days of the depression"; and with foreign markets narrowed that is doubtless true. Mr. Wallace again presents himself as an advocate of the "middle course" between a domestic crop and unrestricted production.

Plainly, however, the "middle course" is not new. It is the course that has been tried since 1933. In the April, 1935, issue of this Letter the following statement was made:

> Evidently this country is at a fork of the road in its cotton policies, with the choice between meeting other producers in the world markets on competitive terms, or withdrawing from the world markets to an increasing extent. The officials who are determining our cotton policies for the most part seek to find a middle course, and sincerely believe that there is a middle road combining restriction and a substantial volume of exports. But . . . the longer price-pegging is attempted, the more will foreign competition be encouraged and consumption of American discouraged, and the greater will be the crop restriction necessary to support the American price. In truth, there is no certain stopping place on this road short of the disappearance of all exports and the limitation of the crop to domestic requirements. Fortunately that end is not imminent, but it should be clear that restriction of the crop of this country may require more and more restriction to achieve its purposes. The real question is whether the country can afford it.

This describes the situation in 1935. The middle road has been followed since, with the result that the world surplus has climbed to an all-time record. The "only certain stopping place" referred to above is the same as that described by Mr. Wallace in the first of the quotations on the preceding page.

A Constructive Policy

What policies can be put into effect which will ultimately put the cotton growing industry of the South on a prosperous basis without Government financial aid? Clearly the way out is not restriction to domestic needs, which would reduce the acreage to 18,000,000 as Mr. Wallace says, and probably less. This would involve moving half of the cotton farmers into other occupations, and scrapping half of the gins, warehouses, and transportation and merchandising facilities which have been created, ending the employment they give.

On the other hand, the record high yield per acre this season gives the clue to a constructive policy. It has been demonstrated over and over, on experimental areas, that the application of the most up-to-date cultural methods, use of the best seed and modern equipment, and thorough-going soil conservation practices, can produce per acre yields far in excess of the averages commonly recorded. Many experts think there is nothing impracticable in the idea that under acreage restriction the average yield over the Belt could be raised to between 300 and 350 lbs. per acre. Yields of this character, even on a controlled acreage of around 30,000,000, would mean low prices, and the low prices, if accepted without resort to pegging operations, would force countries which could not meet them out of the competitive race. On the other hand, they would reduce costs in this country far below any heretofore known, and put cotton growing on the sure foundation of the most efficient and lowest-cost operations.

This may appear fanciful to some, but is there any other real solution to the cotton problem? Accepting the fact that the Federal Treasury will be paying subsidies to cotton growers for some years to come, is there any hope of ending them at any time except by turning them into a powerful influence for increasing yields, improving quality and lowering costs? They already operate in that direction through the Soil Conservation Act, which tends to concentrate cotton growing on the best land of each farmer. However, should all farmers be entitled to benefits, even those whose best land is poorer than the poorest land of others? Should subsidies be paid to growers who are backward in their cultural methods and heedless in their seed selection, and thereby contribute to the deterioration in the quality of American cotton which is so much complained of? If the Department of Agriculture is to pay farmers, can it not choose what farmers to pay, and require them to plant seed of its selection and to adhere to prescribed cultural standards before they are paid? Is this too idealistic?

One of the great fallacies of the cotton program is the assumption that all those who are engaged in cotton growing are entitled to remain in that occupation, even to the point of being supported by the rest of the people. All are eligible for the subsidies. This is merely protecting the inefficient at everybody's expense, and inevitably leads to balancing the market position on the basis of scarcity and high cost, instead of abundance and low cost. If the same principle were applied to all workers its fallacy would be obvious, for the scarcity would be general, and no one would be prosperous.

The evidence unfortunately indicates that in cotton America has chosen, involuntarily perhaps, and even unknowingly, to go too far along the road of nationalistic policy. It is more difficult to turn back than it was a few years ago, but it is not too late.

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